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Weekly Global Market Commentary

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In Defense of Defense Stocks

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Investor sentiment toward U.S. defense stocks has turned increasingly cautious. Since the U.S. election last November, the largest publicly traded American defense contractors have significantly underperformed the broader market. The Dow Jones U.S. Defense Index has declined 17%, while the MSCI World Stock Index has gained 1.4% over the same period.

A key factor behind this underperformance is President Trump's unconventional approach to economic and defense policy. Unlike traditional Republicans, who have historically favored a laissez-faire stance on business, Trump has demonstrated a more interventionist style. As a populist, he frequently seeks to micromanage business operations, often dictating where companies should locate their manufacturing facilities. His vision of revitalizing American industry prioritizes reshoring production, even at the cost of higher prices for consumers.

Another critical distinction of this administration is its approach to military spending. While past Republican administrations have typically pursued aggressive defense policies, Trump has emphasized cost-cutting and military de-escalation. In February 2025, he appointed Elon Musk as the government efficiency czar, tasking him with identifying and eliminating waste and fraud within the Department of Defense's $850 billion budget. Shortly thereafter, Defense Secretary Pete Hegseth instructed military services to find $50 billion in potential budget cuts—an 8% reduction—to reallocate funds toward the administration's defense priorities.

For major U.S. defense contractors such as Lockheed Martin, General Dynamics, Northrop Grumman, and L3Harris, the federal government is essentially their sole customer. This dependence on government contracts makes them particularly vulnerable to shifts in political policy and budgetary uncertainty.

Meanwhile, European defense contractors are experiencing a contrasting dynamic. The White House has increasingly signaled that European nations must take greater financial responsibility for their own defense. As the war in Ukraine continues, Trump's discussions with European leaders have resulted in commitments to boost military spending. This has driven strong stock price appreciation for European defense firms. Germany's Rheinmetall, for example, has surged 87% year-to-date, while the U.K.'s BAE Systems is up 41%.

Beyond projected cash flows, another key driver of stock prices is the degree of certainty around those cash flows. Higher uncertainty typically translates to lower valuations. With U.S. defense budget cuts looming, investors are assigning greater risk to the "big six" American defense companies.

However, not all defense firms are equally exposed. Boeing and Raytheon, for instance, stand out due to their significant commercial aviation businesses. Raytheon, the third-largest producer of commercial jet engines, derives approximately 59% of its revenue from the non-military sector. This diversification has helped RTX shares gain 16% year-to-date.

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Looking ahead, U.S. defense companies with exposure to critical spending initiatives and long-term contracts may outperform their peers. In December, I highlighted how the healthcare sector had been overly penalized due to political uncertainties surrounding the new administration. Since then, the MSCI Healthcare Index has climbed 7.38%, outpacing the broader MSCI World Stock Index's 2.63% gain. At current depressed valuations, select U.S. defense stocks may present a similar investment opportunity.

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